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SOME FACTORS TO CONSIDER IN DESIGNING EMPLOYER-SPONSORED DEATH AND DISABILITY BENEFITS

by

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Introduction

Currently, the federal government provides a substantial part of survivor income protection and all disability income protection for federal employees through the Federal Civil Service Retirement System (FCSRS).* In a 1980 study for New York State, Mercer determined that approximately 80% of the value of all employee benefits covering federal employees are provided through FCSRS. This is not unusual in the public sector; most state and local governments also rely on the pension plan as a major source for non-retirement cash benefits -- particularly death and long-term disability benefits.

In the private sector, less emphasis has been placed on the pension plan for providing death and disability income protection. Private employers typically offer substantial death benefit protection to their employees through group term life insurance plans, supplemented by pension plan benefits of one form or another. Similarly, long-term disability protection is commonly provided through long-term disability income (LTD) plans that are established outside of an employer's pension plan. In the public sector, separate LTD plans are rare; disability benefits usually are provided through the employer's pension plan.

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* By death (survivor) benefits, I mean benefits paid to survivors of employees who die during active employment and retirees who die in the course of receiving pension plan benefits. When I refer to disability benefits, I am speaking of permanent and total disability that would qualify an employee for long-term disability benefits from Social Security and/or employer-sponsored disability income arrangements. Short-term disability benefits, also avalilable through employer-provided plans and social insurance programs, are not being considered in this discussion.

The U.S. Senate Committee on Governmental Affairs has asked me to discuss some of the major factors that should be considered in designing death and disability benefits for federal employees. In my view, these considerations should be no different than the criteria other employers would use in designing thoughtful death and disability benefit protection for their employees. Cost aside, the design of these benefits should be based upon:

- established employer objectives; and
- careful consideration of all possible sources of death and disability income protection.

My presentation will discuss the basis of designing death and disability benefits. This discussion is not meant to be exhaustive or technical, and does not intend to cover all sources of death and disability benefits. It is designed only to be a basic introduction to this complex area.

Death Benefits

1. Setting Objectives

The most fundamental step in designing any employee benefit plan is for an employer to identify specific objectives for providing a particular benefit. Some of the questions that should be raised in determining the appropriate design of death benefits are as follows:

- What is the purpose of providing death benefits to federal employees:

- To provide a continuing stream of income for survivors so that they can preserve the level of earnings prior to an employee's death;

- To provide a lump-sum payment that may tide over the family for a specific period of time; or

- To provide minimal benefits for burial expenses, etc?

- Should benefits be provided to survivors of retirees as well as to survivors of active workers?

- Should employees be required to work a minimum period of time in order for survivors to qualify for death benefits? If so, should the service requirement differ for deaths due to occupational and non-occupational causes?

- Who should be considered eligible for these benefits: a surviving spouse, surviving children, surviving parents, or anyone designated by the employee as beneficiary?

- Should married and single employees have the same level of benefits available to them?

- Can benefits be provided in a more tax-efficient manner in one form than in another?

- Should benefits be designed to dovetail other sources of employer-provided death benefits, including those payable under Social Security and workers' compensation?

- What can be learned from the current design of death benefits for federal employees?

  - Are there any gaps or duplications in benefits?

  - Are all groups of employees being covered equally (e.g., single and married, young, middle-aged and older employees)?

These are only a few of the key questions that need to be raised in setting objectives for the design of death benefits. They address benefit levels, benefit eligibility, equity in entitlement to benefits, and tax treatment of benefits. I will cover each of these areas briefly as I review the types of death benefits available from Social Security, pension plans, and group term life insurance plans.

2. Sources of Death Benefits

- Social Security: Effective January 1, 1984 all new federal employees will be covered by Social Security, as required by the Social Security Amendments of 1983. Covered employees currently pay 6.7% of their salaries in Social Security taxes up to $37,800 and the federal government pays another 7.0% up to this salary level for each covered employee.

Social Security survivor benefits are important and should be considered the basic level of death benefit protection for federal employees. All other death benefits offered to federal employees through a pension plan, life insurance or any other arrangement should be considered supplemental to Social Security survivor benefits.

There are several types of benefits that may be payable under Social Security when a covered worker dies. Some of these benefits require a deceased worker to have been "currently insured;" others require the person to have been "fully insured" as well. To be currently insured, a person needs six quarters of coverage during the last 13 quarters ending with the quarter in which the person dies. To be fully insured, a person must have between six and 40 quarters of coverage depending upon when the person was born and when the person dies.

In addition to the lump sum $255 benefit payable to a surviving spouse, monthly Social Security survivor benefits can be paid under a variety of circumstances. For example, benefits can be payable to:

- a spouse caring for an eligible child;
- a divorced spouse caring for an eligible child;
- an eligible child;
- a spouse aged 60 or older (50 or older, if completely disabled);

- a divorced wife aged 60 or older (50 or older, if completely disabled) if the marriage lasted at least 10 years; or
- dependent parents aged 62 or older.

Benefits are tax-free, except for survivors who have substantial incomes. Beginning in 1984 a portion of Social Security benefits will be subject to federal income tax when a taxpayer's earnings exceeds the base amount of $25,000 for single taxpayers and $32,000 for married taxpayers filing joint returns.

The value of death benefits provided by Social Security is not generally recognized by the public. The value of Social Security survivor benefits can range from $255 to $200,000 or more, depending upon individual circumstances. Several examples are shown in the following table excerpted from The Coming Revolution in Social Security, by A. Haeworth Robertson. The table presents numerical examples of estimated monthly Social Security death benefits and the actuarial present value of future benefits to survivors of workers dying in January 1980 in selected situations. While the dollar amounts shown here have changed somewhat since these examples were developed, the levels of income replacement have remained approximately level.

Estimated Amount and Value of Social Security Survivors Benefits for Survivors of Workers Dying in January 1980 at Various Ages, Having Had Maximum Career Earnings

Beneficiary[a]	*Monthly Benefit Amount*	*Replacement Ratio*[b]	*Actuarial Present Value of Future Benefits*[c]
(1)	(2)	(3)	(4)
Worker dying at age 25:			
Spouse aged 25 with one child	$849.00	58%	$189,800[d]
Spouse aged 25 with two or more children	990.60	68	221,300[d]
Worker dying at age 35:			
Spouse aged 35 with one child	796.20	54	155,100[e]
Spouse aged 35 with two or more children	928.80	63	172,000[e]
Worker dying at age 55:			
Spouse aged 55 with one child	739.20	50	100,100[f]
Spouse aged 55 with two or more children	862.50	59	103,000[f]

[a]Benefits shown in family examples assume that each family member is dependent on retired worker for support.

[b]This figure is the ratio of the total benefits for 1980 to the average annual maximum taxable earnings during the three-year period 1977–1979; thus, it is the percentage of the final three-year average earnings that is replaced by Social Security benefits during 1980.

[c]This figure represents the amount that, if placed in an interest-bearing account on January 1, 1980, would be just sufficient to pay all monthly benefits as they fell due. It assumes that the family members have average life expectancies and that interest will be earned at a rate equal to the cost-of-living increases each year plus 2½ percent.

[d]Estimate assumes children are ages 1 month and 2 years as of January 1, 1980, and will remain in school until age 22. Single-child estimate assumes child is at lower age. Estimate includes present value of future widow's benefits to spouse, beginning at age 60, of $30,000.

[e]Estimate assumes children are ages 5 and 10 years as of January 1, 1980, and will remain in school until age 22. Single-child estimate assumes child is at lower age. Estimate includes present value of future widow's benefits to spouse, beginning at age 60, of $36,300.

[f]Estimate assumes children are ages 15 and 20 years as of January 1, 1980, and will remain in school until age 22. Single-child estimate assumes child is at lower age. Estimate includes present value of future widow's benefits to spouse, beginning at age 60, of $58,900.

Source: The Coming Revolution in Social Security, by A. Haeworth Robertson (Reston, Va.: Reston Publishing Co., 1981), p. 215.

As this table illustrates, Social Security can be a significant source of death benefits for workers in covered employment, a source that the federal government should consider carefully in determining the appropriate design of supplemental survivor benefits for federal employees who are covered by Social Security.

- Pension Plans: Generally, public and private pension plans provide survivors who meet certain eligibility requirements with some form of death benefit. In the private sector, benefits are limited by IRS plan qualification requirements; the level of death benefits must be incidental to the primary purpose of the pension plan, which is to provide post-retirement income to plan participants. (Technically, this limitation applies to public plans as well, but this and other plan qualification requirements have not been enforced in the public sector.)

The Employee Retirement Income Security Act of 1974 (ERISA) also sets specific requirements that qualified private pension plans must meet in providing death benefits. First, if the plan offers an early retirement benefit, it must give plan participants the opportunity to elect an early survivor annuity. This benefit would be payable to a surviving spouse if the worker dies after reaching early retirement age but before reaching actual retirement. The benefit must equal at least one half of the worker's accrued benefit at the time of death. ERISA also requires that pension benefits for married employees must be paid as a qualified joint and survivor annuity

unless the employee elects to receive the retirement benefit in another form. The joint and survivor annuity gives a retired worker a pension benefit which would be continued at the same amount or at a lower amount to the retiree's surviving spouse. In a contributory pension plan, ERISA also requires that the employee's beneficiary receive a refund of employee contributions plus interest thereon that has not been paid out in pension plan benefits.

Even though these ERISA requirements do not apply to federal pension plans, Congress may want to consider the appropriateness of incorporating them into a newly designed FCSRS.

Pre-retirement death benefits that are offered by pension plans include the following:

- Monthly pension equal to what the deceased employee would have received had that person retired on the date of death.

- Lump-sum payment based on the value of the deceased employee's accrued pension up to the date of death.

- Lump-sum payment based on the value of the projected benefit that would have been earned had the deceased worker continued working until normal retirement age.

- Lump-sum payment (through a group life insurance program) up to one hundred times the expected monthly pension benefit that the deceased employee would have received had that person reached normal retirement age.

- Lump-sum payment that is designed to meet "final" expenses of the deceased worker (burial, funeral expenses, etc.).

For post-retirement death, a pension plan usually gives participants the opportunity to choose among several survivor options (in addition to the qualified joint and survivor option required by ERISA). The plan may also offer survivors a small lump-sum payment for funeral and burial expenses.

It is important to recognize that the various forms of death benefits provided through a pension plan are not necessarily available to all survivors. Some pension plans specifically require that the beneficiary be a surviving spouse or perhaps a surviving child. This requirement could exclude survivors of single employees from qualifying for a death benefit. Other limitations on survivor benefits also exist.

Monthly survivor benefits are taxed as ordinary income (after the retiree recovers the value of any employee contributions that were made). Lump-sum payments also are generally taxed as ordinary income, although they may be eligible for favorable ten-year forward averaging (designed to lower the tax rate on the distribution). The first $5,000 of a lump-sum payment is exempt from federal taxation.

- <u>Group Term Life Insurance</u>: Employer-sponsored group term life insurance plans are a third major source of death benefit protection for employees and their families. For white collar workers, benefits usually are a multiple of a person's annual base salary. In the private sector, the typical range of

coverage is between one and two times annual base salary for full-time employees, rounded to the next higher $1,000. In large corporations, this basic level of life insurance coverage usually is non-contributory.

A life insurance plan almost always contains an accidental death and dismemberment provision, which provides additional benefits in case of accidental death. Some employers continue life insurance coverage after retirement at reduced levels, while others terminate coverage when an employee retires.

An employee has the latitude of naming <u>any</u> beneficiary desired (or else the payment is made to the person's estate). As noted previously, pension plans may allow employees less flexibility in designating a beneficiary and, thus, may exclude certain classes of employees altogether from employer-provided death benefit protection. Many employers cover all active employees under their life insurance plans from the date of hire or after a relatively short waiting period. This gives employees of all ages, regardless of marital status, a basic source of death benefit protection.

While survivor distributions from pension plans are taxed as ordinary income, group term life insurance payments are tax free to the designated beneficiary, although subject to tax on the deceased person's gross estate.

- Summary: I have identified three major sources of survivor income that are available in the public and private sectors. Social Security can provide substantial survivor income to individuals, depending upon specific circumstances, or it can provide virtually nothing. In designing survivor benefits for federal employees, Congress should recognize the possible range of death benefits that may be payable under Social Security.

Employer-sponsored pension plans and life insurance plans can provide valuable death benefit protection for employees that supplements basic Social Security benefits. Each plan has advantages and disadvantages which decision makers should understand. Particular attention should be given to the needs of employees in different age groups, the availability of benefits to married, single, young and older employees, the level of benefits offered to survivors under different circumstances, and the tax treatment of pension and life insurance benefits.

Unless care is taken in designing survivor benefits, employees who have the greatest need for this protection may find that they have the least adequate coverage, while other employees, who have a lesser need for death benefit protection, may have the best protection.

A suggested plan of action for designing federal employee survivor income benefits would be to:

(1) Establish objectives that meet the needs of the federal government and federal employees.

(2) Establish Social Security as the basic level of death benefit protection.

(3) Design supplemental benefits, utilizing the best features of pension and group term life insurance plans, and other available sources of survivor income.

Long-Term Disability (LTD) Benefits

The financial impact of permanent and total disability on employees and their families can be devastating if there is no disability income protection. The results can be more severe than the death of an employee, yet protection against income loss arising from disability generally has not been given high priority.

1. Setting Objectives

The fundamental design of LTD benefits, as with the design of survivor benefits, depends upon an employer's objectives for offering this protection to employees. Some of the basic questions that Congress should ask in designing LTD benefits for federal employees follow.

- What level of disability income protection should be provided to employees?

- Would any groups of federal employees still be exposed to the risk of substantial income loss by choosing one form of disability income protection over another?

- What definition of long-term disability should be used?

- Who should be eligible for this protection?

- Should there be a waiting period for new employees?

- What is the most efficient and effective means of providing LTD benefits?

- In reviewing current LTD protection for federal employees, what gaps and duplications in benefits exist?

2. Sources of LTD Benefits

- <u>Social Security</u>: Social Security disability benefits are only payable if a covered employee is so severely disabled that the person cannot perform any substantial gainful work and the disability is expected to last at least 12 months or result in death. Furthermore, a person must have been disabled for five full consecutive months in order to begin receiving benefits. And last, disability benefits will be payable only if the person has paid Social Security taxes for a specified number of quarters, which would vary based upon a person's date of birth and date of disability.

  Because of Social Security's stringent eligibility requirements, many disabled employees do not qualify for these benefits. If these eligibility requirements are met, there is no guarantee that Social Security disability benefits will be adequate. Benefit levels

depend upon a person's covered earnings, number of family dependents, and to some extent the age when a person becomes disabled. The following table, excerpted from A. Haeworth Robertson's book, The Coming Revolution of Social Security, illustrates the wide variation in levels of disability benefits available under Social Security by earnings level.

Ratio of Initial Social Security Disability Benefits to Average Earnings Prior to Disability for Illustrative Workers[a]

Earnings Level of Worker[c]	*Replacement Ratio[b] When Disability Began at . .*	
	Age 25	*Age 50*
(1)	(2)	(3)
	Single Worker	
Minimum	70%	70%
Average	54	53
Maximum	44	39
Twice Maximum	22	20
	Married Worker with Eligible Family[d]	
Minimum	110%	110%
Average	99	97
Maximum	76	69
Twice Maximum	38	34

[a]Public Law 96-265 (enacted June 9, 1980) made a number of changes in the way benefits are calculated for disabled workers and their families. The disabled workers in this example would not be affected; however, benefits would be reduced somewhat for persons becoming eligible for family disability benefits in the future.

[b]Replacement ratio equals the disability benefits payable in the first year divided by the average of the last three full years of earnings prior to disablement. In each example the worker is assumed to become disabled in July 1979 and to begin receiving benefits in January 1980.

[c]"Minimum" denotes earnings equal to the minimum wage in each year. "Average" means earnings in each year equal to the average wages of all covered employees. "Maximum" and "Twice Maximum" refer to the level of the maximum contribution and benefit base under Social Security.

[d]Family is assumed to consist of worker, spouse, and one or more children.

Source: The Coming Revolution in Social Security, by A. Haeworth Robertson (Reston, Va.: Reston Publishing Co., 1981), p. 234.

Although this table is based upon benefits commencing in January 1980, the relative levels of income replacement are still valid today. Social Security disability benefits can provide almost full replacement of lost income for people in lower-salary brackets and replace very little for those in the upper brackets. The challenge to employers is to design an LTD program that supplements Social Security benefits and provides appropriate income replacement to employees at each salary level.

- Pension Plan Benefits: Employers sometimes choose to provide employees with disability income protection through their pension plans. This can be accomplished in several ways. For example, the disability benefit may be established as a fixed percentage of the person's base compensation as of the date of disability, a percentage of the person's accrued pension benefit, or a percentage of the person's pension benefit projected to normal retirement age.

  Disability benefits typically are paid on a monthly basis until the employee (if unrecovered) reaches normal retirement age. At that time, the disabled employee may be reclassified as a retiree. He then might become entitled to a pension benefit based upon compensation at the time of disability and service projected from the date of disability up to normal retirement age. When disability occurs after reaching early retirement age, the disabled employee may begin receiving regular early retirement

benefits instead of disability benefits.

Typically, employees must meet a length-of-service requirement under the employer's pension plan to qualify for disability benefits. The service requirement may be 5 years (most commonly found in the public sector), 10 years, and sometimes 15 years or longer. FCSRS currently requires 5 years. This means that employees who do not meet the pension plan's length-of-service requirement would not have any disability income protection unless covered by a separate LTD plan. The most vulnerable employees are young, short-service workers with growing family responsibilities.

All disability benefits are taxed as ordinary income unless a disabled employee becomes eligible for the tax credit for the elderly and disabled.

- <u>Long-Term Disability Income Plan Benefits</u>: Many private employers provide their employees with disability income protection through long-term disability income plans that are independent of employer-sponsored pension plans. These plans may be insured or self-insured.

Generally, coverage is available to all full-time employees as of the date of hire or after a short waiting period. These plans provide disability income protection equal to a percentage of an employee's base salary at the time of disability, usually ranging between 50% and 66 2/3% of salary. Benefits ordinarily commence

3 to 6 months after the onset of disability if other plan requirements have been met. Benefits are offset by Social Security and other sources of disability income.

One of the principal advantages of providing disability income protection through a separate LTD plan is flexibility in meeting employer and employee needs. For example, there is ease in coordinating benefits with Social Security and other sources of disability income without being concerned about meeting IRS integration rules that apply to pension plans. Furthermore, all covered employees can be offered the same level of disability income protection, regardless of length of service with the employer; short-service employees would receive the same level of disability benefits as career employees.

When a separate LTD plan is offered, a well-designed pension plan ordinarily would not offer additional disability benefits. Instead, it might grant disabled employees credited service from the date of disability up to normal retirement age, when LTD plan benefits usually cease. The disabled employee would then be reclassified as a retiree and his pension (under a defined benefit plan) would be based on salary at the time of disability, years of credited service up to the date of disability, and projected service from the onset of disability to normal retirement age.

The tax treatment of disability income benefits payable from an LTD plan and a pension plan is the same; the entire amount is taxed as ordinary income unless a disabled employee qualifies for the tax credit available to the elderly and disabled.

Summary

The purpose of my presentation today was to discuss the basis of designing death and disability benefits for federal employees. As I stated at the onset, the process of designing these benefits for federal employees should be no different than the process used by other major employers in designing benefits for their employees.

The first step is to set forth specific objectives that meet both employee and employer needs. Then, it is essential that all available sources of death and disability benefits be understood and evaluated carefully. Social Security should be established as the basic level of death and disability income protection; employer-provided death and disability benefits should be designed to supplement Social Security benefits. Flexibility, tax treatment of benefits, and equity across different employee groups are just a few of the factors that should be considered in determining the most appropriate design of supplemental death and disability benefits for federal employees. The key to success will be prudent and thoughtful planning.